

**Internal Revenue Service**

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Person To Contact:

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Date: October 18, 2006

X =

Y =

State =

A =

B =

M =

D1 =

D2 =

D3 =

D4 =

D5 =

Dear :

This letter responds to a letter, dated June 16, 2006, and subsequent correspondence, on behalf of X from X's authorized representative, requesting inadvertent invalid election relief under §1362(f) of the Internal Revenue Code.

## FACTS

According to the information submitted, X was incorporated under the laws of State on D1, and timely filed a Form 2553, Election by a Small Business Corporation, effective D2. When X filed its Form 2553, X's shareholders were individuals, and Y, an S corporation. The shareholders of Y were A and B, both individuals. Y, as an S corporation, was an ineligible shareholder of another S corporation that was not a qualified subchapter S subsidiary. In D3, X was advised by its accountant that Y was an ineligible shareholder of an S corporation and that X's S corporation election was ineffective. On D5, Y was merged into X and distributed its shares of X to A and B. X filed for a private letter ruling soon afterward.

From D2, onward, X represents that it filed its tax returns as if it were an S corporation. This includes allocating its items of income, loss, deduction, and credit to all of its shareholders, including Y. Y in turn, allocated those items to its shareholders, A and B. X represents that the amount of tax paid during this period was the same as if A and B would have held the stock in X directly. In addition, X and its shareholders represent that its ineffective S corporation election was inadvertent and was not motivated by tax avoidance or retroactive tax planning. X and its shareholders agree to make any adjustments consistent with the treatment of X as an S corporation that the Secretary may require.

X requests a ruling that its invalid S corporation election was inadvertent within the meaning of §1362(f).

## LAW AND ANALYSIS

Section 1361(a) provides that the term "S corporation" means, with respect to any taxable year, a small business corporation for which an election under §1362(a) is in effect for such year.

Section 1361(b)(1)(B) provides, in part, that the term "small business corporation" means a domestic corporation which is not an ineligible corporation and which does not have as a shareholder a person (other than an estate, a trust described in §1361(c)(2), or an organization described in §1361(c)(6)) who is not an individual.

Section 1362(a) provides that, except as provided in §1362(g), a small business corporation may elect to be an S corporation.

Section 1362(f) provides, in part, that if (1) an election under §1362(a) by any corporation was not effective for the taxable year for which made by reason of a failure to meet the requirements of §1361(b), (2) the Secretary determines that the circumstances resulting in such ineffectiveness were inadvertent, (3) no later than a reasonable period of time after discovery of the circumstances resulting in such ineffectiveness, steps were taken so that the corporation is a small business corporation, and (4) the corporation, and each person who was a shareholder in the corporation at any time during the period specified pursuant to §1362(f), agrees to make adjustments (consistent with the treatment of the corporation as an S corporation) as may be required by the Secretary with respect to such period, then, notwithstanding the circumstances resulting in such ineffectiveness, such corporation shall be treated as an S corporation during the period specified by the Secretary.

## CONCLUSION

Based solely on the facts submitted and representations made, we conclude that X's S corporation election was ineffective for the taxable year beginning on D2 because Y was an ineligible shareholder of X. We further conclude that the ineffectiveness of X's S corporation election constituted an inadvertent invalid election within the meaning of §1362(f).

Under the provisions of §1362(f), X will be treated as an S corporation from D2, and thereafter, provided that, apart from the inadvertent invalid election ruling above, X's S corporation election was otherwise valid and has not otherwise terminated under §1362(d). From D2 until D4, A and B will each be treated as owning M percent of the X stock held by Y. Accordingly, from D2, the shareholders of X, including A and B, must include their pro rata share of the separately stated and non-separately stated computed items of X as provided in §1366, make any adjustments to basis as provided in §1367, and take into account any distributions made by X as provided in §1368. If X and its shareholders fail to treat X as described above, this ruling will be null and void.

Except as specifically set forth above, no opinion is expressed concerning the federal tax consequences of the facts described above under any other provision of the Code. Specifically, no opinion is expressed regarding whether X is otherwise eligible to be an S corporation.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

In accordance with a power of attorney on file with this office, a copy of this letter is being sent to X's authorized representative.

Sincerely,

Mary Beth Collins  
Senior Technician Reviewer, Branch 3  
Office of the Associate Chief Counsel  
(Passthroughs & Special Industries)

Enclosures (2)

Copy of this letter

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